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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

~~72~~-1585

HOOVER, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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Petitioner prays that a Writ of Certiorari issue to review the Order of the United States Court of Appeals for the Sixth Circuit entered on February 27, 1973.

CITATIONS TO ORDERS AND OPINIONS BELOW

The opinion and decision of the United States Tax Court deciding in favor of the Respondent that there are deficiencies in corporate income tax due from Hoover, Inc. in the amount of $201,636.36 for the years 1963 through 1967 is printed in Appendices C and D and were unofficially reported at T. C. Memo 1972-54. The Order of the Court of Appeals reversing in part and affirming

in part the Tax Court is printed in Appendix A and is not officially reported.

JURISDICTION

The Order of the Court of Appeals was entered on February 27, 1973. The Court of Appeals stayed its mandate for sixty days on March 27, 1973 on the grounds that the Petitioner was preparing a Petition for Writ of Certiorari.

The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

THE QUESTIONS PRESENTED

1. Where the Tax Court and the Court of Appeals found the Petitioner corporation to be an indemnitor and the corporation sustains a loss as such, is a deduction permitted pursuant to Section 165(a) of the Internal Revenue Code as a matter of law?

2. Did the lower courts misapply the principles of law established by this Court in *Gregory* v. *Helvering, C.I.R.* v. *Court Holding Company, Higgins* v. *Smith* and *Minnesota Tea Company* v. *Helvering,* so that their decisions are in direct conflict with this Court and the Circuit Courts?

3. As a matter of law, is a transfer from the sole stockholder to the corporation a bonafide indebtedness when the legal criteria set forth in the statute and case law establishes a loan?

CONSTITUTIONAL PROVISIONS, STATUTES AND RULES INVOLVED

The statutes involved are the Sections of the Internal Revenue Code of 1954 as amended which is codified as

Title 26 of the United States Code. The Sections relied upon by the Petitioner are as follows: [1]

SEC. 165. LOSSES

(a) General Rule.—There shall be allowed as a deduction *any loss* sustained during the taxable year and not compensated for by insurance or otherwise. (emphasis added)

SEC. 163. DEDUCTIONS - INTEREST.

(a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

STATEMENT

The Tax Court found that Hoover, Inc., a Tennessee corporation with its principal place of business in Nashville, Tennessee, since 1960 has been engaged in quarrying and selling limestone and related products for use in highway and other construction.[2] E. H. Hoover, Jr., during the time in question, was President and owned all of the stock of this corporation.[3]

Hot Mix, Inc. has since 1960 engaged in the business of supplying paving materials and services used for road and highway construction.[4] John L. Burns, Inc. (Burns, Inc.) has been primarily a licensed road grading and general highway construction contractor.[5]

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[1] Sections 165 and 163 are printed in their entirety in Appendix E hereto.

[2] Tax Court Memo Opinion, Appendix C, p. A-7.

[3] Memo Opinion, Appendix C, p. A-7.

[4] Memo Opinion, Appendix C, p. A-7.

[5] Memo Opinion, Appendix C, p. A-7.

In 1964, E. H. Hoover, Jr., having owned 35% of the stock of Hot Mix, Inc., acquired its remaining stock. In 1964, Burns, Inc. became a wholly owned subsidiary of Hot Mix, Inc.[6]

The Tax Court found that Hoover, Inc., Hot Mix, Inc. and Burns, Inc. have from time to time participated in highway construction involving on one project the services and products of two or three of these businesses. It further found that the inter-relationship of these corporations has enabled them to offer general contracting services, subcontracting services and the supplying of materials and to bid on and participate in highway contracting more advantageously than any one of them could do alone.[7]

The Tax Court found that Hoover, Inc. acted only as a supplier and not as a contractor or subcontractor on highway projects and that having available Hot Mix, Inc. as a paving contractor with which to jointly negotiate "package" proposals, had an advantage in securing stone and aggregate sales to other contractors in several states on various roadway construction jobs.[8]

The Tax Court found that Petitioner would require that its stone must be used if Hot Mix, Inc. were permitted to participate. It further found that when a job was bid and a contract obtained by the prime or subcontractor member of this team, Petitioner would then bring in its equipment for opening a limestone quarry and crush the product for sale to Burns, Inc. or Hot Mix, Inc. The Tax Court found that as a result of having a quarry established in a particular construction area, the team could bid competitively on subsequent contracts in the area, and Petitioner as supplier, and Hot Mix,

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[6] Memo Opinion, Appendix C, p. A-7.

[7] Memo Opinion, Appendix C, pp. A-10, 11.

[8] Memo Opinion, Appendix C, pp. A-10, 11.

Inc., acting as a paving subcontractor, could sell their products and services even if the team was not successful in bidding as the prime contractor.[9]

The Tax Court found that Burns, Inc. contracted with the State of Georgia on January 5, 1961 to furnish labor and materials to do certain work on Interstate Highway Project I-75-3 in Georgia. After the work was begun on this project, Burns, Inc. had difficulty in meeting its contract commitments and subsequently, suffered financial loss on the project.[10]

The Fidelity & Casualty Company of New York (Fidelity) as surety furnished bid and performance bonds necessary for Petitioner, Hot Mix, Inc., and Burns, Inc. to bid and perform highway construction jobs.[11]

The Tax Court found that on December 12, 1963, Hot Mix, Inc. and Burns, Inc., as principles, and Hoover, Inc., as indemnitor, entered into a "General Contract of Indemnity" under which all agreed to indemnify Fidelity against any loss resulting from liability on any surety bond which Fidelity might sustain as surety on behalf of either of the principles.[12]

The Tax Court found that on April 13, 1966, a "General Contract of Indemnity" was entered into by Burns, Inc., as principle, and Hot Mix, Inc., two other subsidiaries of Hot Mix, Inc., and Hoover, Inc. as indemnitors and the Continental Insurance Company (an affiliated company of Fidelity) providing that the indemnitors would indemnify Continental in the event of any claims

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[9] Memo Opinion, Appendix C, p. A-11.

[10] Memo Opinion, Appendix C, pp. A-11, 12.

[11] Memo Opinion, Appendix C, p. A-12.

[12] Memo Opinion, Appendix C, p. A-13.

or other losses which the company might sustain as surety on behalf of the principle.[13]

The Tax Court found that after Burns, Inc. began having financial difficulty, Fidelity gave its guaranty to the Commerce Union Bank of Nashville (Bank) in order to obtain for Burns, Inc. and Hot Mix, Inc. a $600,000.00 line of credit.[14] In addition, the Bank required Hot Mix, Inc., its other subsidiaries including Burns, Inc. and E. H. Hoover, Jr. to execute a guaranty to the Bank. All the capital stock of Petitioner, Hot Mix, Inc. and its subsidiaries was deposited with the Bank as collateral.[15] One year later E. H. Hoover, Jr., pledged and assigned $800,000.00 of his personal funds as additional security to Fidelity.[16]

Between October, 1963 and July, 1964, Burns, Inc. borrowed $700,000.00 from the Bank under the lines of credit guaranteed by Fidelity. Burns, Inc. owed to the Bank $594,000.00 on December 1, 1966.[17]

On that date, Fidelity demanded of E. H. Hoover, Jr. that he take such action as required so that Fidelity would be released from any and all obligations which it had to the Bank pursuant to its guaranty.[18]

Fidelity liquidated the personal assets of E. H. Hoover, Jr. and returned them to him.[19]

On December 29, 1966, E. H. Hoover, Jr. by his personal check to Hoover, Inc. loaned it $594,000.00 and re-

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[13] Memo Opinion, Appendix C, pp. A-14, 15.

[14] Memo Opinion, Appendix C, p. A-12.

[15] Memo Opinion, Appendix C, p. A-12.

[16] Memo Opinion, Appendix C, p. A-14.

[17] Memo Opinion, Appendix C, p. A-15.

[18] Memo Opinion, Appendix C, pp. A-15, 16.

[19] Memo Opinion, Appendix C, pp. A-16, 17.

ceived an interest-bearing promissory note. The same day, Hoover, Inc., being liable to Fidelity as an indemnitor, advanced the moneys to Burns, Inc. which in turn paid its indebtedness to the Bank, thereby discharging Fidelity as a guarantor of the Bank.[20]

The effect of the transfers of funds on December 29, 1966 was to insure that E. H. Hoover, Jr. did not loan his personal assets to the then insolvent Burns, Inc. He loaned his $594,000.00 to Hoover, Inc., as it was a solvent, going business from which he expected to recover his loan, plus interest.[21]

The Tax Court concluded that Hoover, Inc. was merely a "conduit" and an unnecessary step in the transactions of December 29, 1966 which was without business purpose and denied it the claimed deduction.[22] It held that if E. H. Hoover, Jr. could place the loss on his corporation, he would not have to bear it personally.[23] Further, that E. H. Hoover, Jr. by advancing the funds to Hoover, Inc. was afforded a source of repayment of funds.[24] It also held without discussion that no debt was created between E. H. Hoover, Jr. when he advanced $594,000.00 to Petitioner and disallowed Petitioner's interest deduction under Section 163(a).[25]

The Tax Court found that Petitioner was an indemnitor, but denied the Petitioner a loss as an indemnitor under Section 165(a) stating that there must be a valid business purpose and that there was none in this case.[26]

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[20] Memo Opinion, Appendix C, p. A-19.

[21] Memo Opinion, Appendix C, pp. A-22, 23.

[22] Memo Opinion, Appendix C, p. A-26.

[23] Memo Opinion, Appendix C, p. A-24.

[24] Memo Opinion, Appendix C, pp. A-23, 24.

[25] Memo Opinion, Appendix C, p. A-26.

[26] Memo Opinion, Appendix C, pp. A-13, 14, 26.

The Court of Appeals in a three paragraph Order held that the Tax Court was clearly erroneous in finding that Petitioner was a guarantor of the Bank. On this point, the Court of Appeals was correct because Petitioner was an indemnitor of Fidelity which was a guarantor of the Bank. However, the Court of Appeals improperly applied the law in affirming the decision of the Tax Court as shall be shown.[27]

REASONS FOR GRANTING THE WRIT

The decisions below should be reviewed pursuant to Rule 19(1)(b) because the Court of Appeals has decided an important question of federal law which has not been, but should be, settled by this Court; and has decided questions of federal law in a way in conflict with the applicable decisions of this Court and other Circuit Courts.

I

WHERE THE TAX COURT AND THE COURT OF APPEALS FOUND THE PETITIONER CORPORATION TO BE AN INDEMNITOR AND THE CORPORATION SUSTAINS A LOSS AS SUCH, IS A DEDUCTION PERMITTED PURSUANT TO SECTION 165(a) OF THE INTERNAL REVENUE CODE AS A MATTER OF LAW?

The Petitioner first became obligated to Fidelity in 1963 as an indemnitor of the liabilities of Burns, Inc. and Hot Mix, Inc. Fidelity, in turn, had guaranteed the indebtedness of Burns, Inc. at the Bank. Petitioner had given the indemnity to Fidelity so that it would continue as surety on highway construction performance bonds written for Burns, Inc. and Hot Mix, Inc. and would issue bonds for future highway projects.

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[27] Order of Court of Appeals, Appendix A, pp. A-1, 2.

Having recognized that the Petitioner was an indemnitor, the Tax Court nevertheless denied Petitioner's claim that it was entitled to deduct as an indemnitor's loss under Section 165(a) the amount it advanced to Burns, Inc. in December, 1966 pursuant to its indemnity obligation. When Petitioner paid $594,000.00 to Burns, Inc. on December 29, which Burns, Inc. in turn paid to the Bank and thereby released Fidelity on its guaranty to the Bank, Petitioner was in turn released from its liability as an indemnitor to Fidelity for the $594,000.00.

The lower courts improperly applied Section 165(a)[28] which specifically applies to corporations and provides:

> "There shall be allowed as a deduction *any loss* sustained during the taxable year and not compensated for by insurance or otherwise." (emphasis added)

Merten's Law of Federal Taxation sets forth the general rule on the deductibility of an indemnitor's loss as follows:[29]

> ". . . a contract of indemnity is an original undertaking and independent of any collateral contract and *creates a primary liability* . . . payment under an indemnity contract gives rise to *a loss deduction* but not a bad debt deduction." (emphasis added)

In support of its position Hoover, Inc. relies on *Santa Anita Consolidated, Inc.* v. *Commissioner*[30] and *Howell* v. *Commissioner*.[31]

In *Santa Anita Consolidated, Inc.* v. *Commissioner*, *supra*, LATC and CBS in 1959 organized a corporation (POP) to construct and operate an amusement park, investing $1.8 million in stock and guaranteeing a line

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[28] The full text of Section 165 is printed in Appendix E.

[29] Merten's Law of Federal Income Taxation Sec. 28.70.

[30] 50 T.C. 536 (1968) acq., 1969-2 CB 25.

[31] 69 F.2d 447 (CCA 8, 1934).

of credit of $8.75 million. In 1959 LATC transferred its POP stock and paid $4.39 million to Pacific, an unrelated corporation, and received *a release* of its liabilities as guarantor. LATC, the taxpayer, had no right to compensation for its loss under the guaranty by insurance, subrogation or otherwise. The Tax Court held that LATC incurred a loss in 1959 deductible under Section 165(a) for $4.39 million on payment for its release of the guaranty obligation, which payment was irretrievably lost in a transaction closed in 1959. The Court held:[32]

> "Since petitioner suffered a noncompensated loss in 1959, not within the provisions of Section 166, it follows that it is entitled to deduct the $4,396,000 payment under Section 165(a) as claimed."

Other cases supporting this proposition are *Spring City F. Co.* v. *Commissioner*[33] and *D. J. Condit.*[34]

It is clear from the authorities that when a corporate taxpayer such as Hoover, Inc. makes an advance which is not properly considered a loan giving rise to a bad debt (which Hoover, Inc., in agreement with the Tax Court, concedes), the taxpayer is entitled to a deduction under Section 165(a) for a loss not otherwise compensated. That is the situation here.

The Tax Court properly here found the advance was a loss. It had been made because of Petitioner's obligation under the indemnity agreements, so it was plainly a loss of an indemnitor within the meaning of Section 165(a) as applied in the cases cited.

The Tax Court erroneously concluded that Petitioner is not entitled to a loss under Section 165(a) since it had "no valid business purpose" for the December 1966 transactions.

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[32] 50 T.C. 536, 561 (1968) acq., 1969-2 CB 25.

[33] 292 U.S. 182 (1934).

[34] 40 T.C. 24 (1963) affd. 333 F.2d 585 (CCA 10, 1964).

The conclusion of the Tax Court affirmed by the Court of Appeals is contrary to the clear language of the Internal Revenue Code because Section 165(a) does not require that there be "a valid business purpose" before a corporation may take a loss under that code section.

Section 165, which is reproduced in full in Appendix E, puts no limitation on the losses that are deductible by corporations. The section clearly draws a distinction between losses allowable to individuals and losses allowable to corporations and the legislative history of Section 165 indicates that such a distinction was intended in the 1939 Code under Sections 23(e) and 23(f).

Absent any lack of clarity in the meaning of the law set forth in Section 165, the lower court was without authority to interject the "business purpose test" as a requisite to the allowance of a deduction under this Section.

The Tax Court cited in support of its conclusion, that Petitioner could not take a loss under Section 165(a), *International Trading Company*[35] and *Richard R. Riss, Sr.*[36] In these cases a divided Tax Court for the first time set up the test that a corporation may not take a 165(a) loss on property unless it is "held for use in its trade or business." The strong dissents argue that a corporation may deduct under Section 156(a) "any loss" sustained and that Congress did not intend that there must be a business purpose. *International Trading Company, supra,* was submitted to the Court of Appeals for the Seventh Circuit in April, 1973, but has not been decided. *International* and *Riss supra,* raised the "business purpose test" for corporations under 165(a) for the first time.

This case presents an important question of federal law as to whether or not the "business purpose test"

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[35] 57 T.C. 455 (Dec. 28, 1971), No. 46; CCH Dec. 31, 132; appealed to Court of Appeals, 7th.

[36] 57 T.C. 469 (Dec. 30, 1971), No. 47; CCH Dec. 31, 200; appeal nolle pros.

must be met before a corporation may take a loss under Section 165, and this question has not been, but should be settled, by this Court.

This Court has granted certiorari to review the lower courts' interpretation of the tax statutes so that there shall be uniform application of the Internal Revenue Laws. *Turnbow* v. *C.I.R.*,[37] *Parsons* v. *Smith*.[38] Likewise this Court has granted the writ of certiorari where the Tax Court and the Court of Appeals have improperly interpreted a section of the Internal Revenue Law. *C.I.R.* v. *LoBue*.[39]

Petitioner insists that the imposition by the lower courts of the "business purpose test" as a prerequisite to allowing a corporation a 165(a) loss is so important to the uniform application of the tax law that it requires review by this Court.

II

DID THE LOWER COURTS MISAPPLY THE PRINCIPLES OF LAW ESTABLISHED BY THIS COURT IN *GREGORY* v. *HELVERING, C.I.R.* v. *COURT HOLDING COMPANY, HIGGINS* v. *SMITH* AND *MINNESOTA TEA COMPANY* v. *HELVERING*, SO THAT THEIR DECISIONS ARE IN DIRECT CONFLICT WITH THIS COURT AND THE CIRCUIT COURTS?

The Tax Court concluded that the only party to derive a benefit from the method in which the obligation of Burns, Inc. was paid on December 29, 1966 was E. H. Hoover, Jr., personally. It held he was afforded a source of repayment of the funds, and that the Petitioner

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[37] 368 U.S. 337 (1961).

[38] 359 U.S. 215 (1959).

[39] 351 U.S. 243 (1956).

Hoover, Inc. could be saddled with the realized loss so that he would not have to bear it personally. As the controlling stockholder, he could require that the corporation take the loss which caused the Petitioner corporation to be a "mere conduit" having no business purpose in being involved. The lower courts rely on *Gregory* v. *Helvering*,[40] *C.I.R.* v. *Court Holding Company*,[41] *Higgins* v. *Smith*[42] and *Minnesota Tea Company* v. *Helvering*.[43]

The Tax Court concludes that the advance of the money from E. H. Hoover, Jr. to Hoover Inc. and then to Burns, Inc. and subsequently to the Bank must be disregarded as a sham and without economic reality, and the loss of some $594,000.00 must fall on the Petitioner's sole stockholder rather than the Petitioner. The Tax Court having found the close inter-relationship of Petitioner, Hot Mix, Inc. and Burns, Inc. for many years, violates the principles of *Gregory, Court Holding, Higgins and Minnesota Tea, supra*, by only looking at the transaction which occurred on December 29, 1966, rather than examining the entire transaction from its genesis years earlier.

Of course, there is a formal distinction as *Gregory, Court Holding, Higgins* and *Minnesota Tea, supra*, deal deal with corporate reorganizations, liquidations and sale transactions. Here, there is no sale, reorganization or liquidation, but the discharge by Hoover, Inc. as an indemnitor of Fidelity, of a liability incurred three years earlier.

But aside from the formal distinctions, the Tax Court erroneously applied the philosophy of these cases. In

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[40] 293 U.S. 465 (1935).

[41] 324 U.S. 331 (1945).

[42] 308 U.S. 473 (1940).

[43] 302 U.S. 609 (1938).

Court Holding, supra, the Supreme Court emphasizes the search for substance rather than form and declares that "mere formalism, which exists solely to alter tax liabilities" can not be used to disguise the true nature of a transaction. Mere conduits are not to be allowed. *Gregory, supra,* admittedly emphasizes the requirement of a business purpose which may be that of either the corporation or of its stockholders as held in *Survaunt* v. *C.I.R.*,[44] and *Parshelsky's Estate* v. *C.I.R.*,[45] dealing with corporate reorganizations. Even so, the critical factor in *Gregory, supra* as discussed in *Nassau Lens Co.* v. *C.I.R.*[46] was not a tax motive or lack of business purpose, but the "incongruity of the tangible, observable results of the transaction."

The Tax Court concludes that because Petitioner was in a position to save taxes by taking a loss in satisfying its indemnity, such motive is fatal. However, *Gregory, supra,* recognizes that tax liability does not automatically follow because of the stockholder's motive of avoiding taxes. In *U.S.* v. *Cumberland Public Service Co.*,[47] this Court said, "a corporation may liquidate or dissolve without subjecting itself to corporate gains tax, *even though a primary motive is to avoid the burden of corporate taxation.*" (emphasis added)

In December 1966 Hoover, Inc. and its controlling stockholder, both committed on various indemnity agreements, were both faced with deciding exactly how the debt of Burns, Inc. should be absorbed. The Tax Court stresses the fact that Fidelity had, at this time, addressed its demand for payment directly to E. H. Hoover, Jr., and that he had authorized the application

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[44] 162 F.2d 753 (CCA 8, 1947).

[45] 303 F.2d 14 (CCA 2d, 1962).

[46] 308 F.2d 39 (CCA 2d, 1962).

[47] 338 U.S. 451 (1950).

of his pledged funds for the payment of the Bank debt. Therefore, concludes the Opinion, when Fidelity released the funds to E. H. Hoover, Jr. for transfer to Hoover, Inc., to provide the funds for its own advance to Burns, Inc., Hoover, Inc. was nothing more than a conduit. It was not a "necessary step."

We submit that it matters not to whom Fidelity formally addressed its demand. It simply wanted payment to the Bank made through Burns, Inc. and not through Fidelity. It makes no sense in determining what tax liabilities might be within the Hoover "family", to say that the manner in which Fidelity addressed a demand could change the results. Rather, the reality of the entire transaction as related to the business purposes of the Hoover corporation, and E. H. Hoover, Jr., should be determinative. And on whom Hoover might actually call to make the advance to Burns, Inc. is far more significant than Fidelity's call.

The Opinion stresses that E. H. Hoover, Jr., by electing to have his coindemnitor Hoover, Inc. advance the funds, thereby acquired for himself a solvent debtor, so that he would not have to bear the ultimate loss personally. We readily agree that this was done. No case holds that a sole stockholder must act to his personal detriment because it might save taxes for his corporation!

The Opinion complains that when E. H. Hoover, Jr. called on his coindemnitor Hoover, Inc. to make the payment and suffer the loss, Hoover, Inc. accomplished a tax savings. This was because Hoover, Inc. had been successful in its part of the team business and therefore had substantial profits, taxes on which could be reduced by suffering this loss. Tax law does not condemn this.

In discussing *Gregory, Court Holding, Higgins, Minnesota Tea Company, supra,* the Second Circuit has pointed out that these cases *do not* hold that tax mini-

mization is an improper objective of corporate management, but that these cases only hold that transactions even though real, may be disregarded if they are but a sham or masquerade. *Gilbert* v. *C.I.R.*[48] So where a transaction otherwise makes sense, the tax motive is immaterial. Here the tax consideration was at most about $200,000.00. *Three times as important* was the question of whether Hoover, Inc. or E. H. Hoover, Jr., personally, would suffer the loss of some $594,000.00. Plainly this was the primary consideration. The incurring of the indemnity by Hoover, Inc., and the decision to pay as payment was made, entirely aside from taxes, all make good sense, and the fact that Hoover, Inc. saved taxes is not unlawful, nor "even mildly unethical". *Marshall* v. *C.I.R.*[49]

In holding that Hoover, Inc. did "not show a sound business purpose in carrying out the transaction in the manner actually employed," the Tax Court failed to do the very thing which *Gregory* itself says must be done: i.e. examine the entire transaction. That Court's own findings of fact recite in detail how the three-corporation-team had developed complementary businesses, how Hoover, Inc., particularly, prospered from that arrangement, and why Hoover, Inc. and E. H. Hoover, Jr. and others were ultimately required to become indemnitors. All of this had developed long before December 1966. Nevertheless, the Tax Court ignores all of this, as a part of the entire transaction. By so doing, it erroneously ignored the mandate of *Gregory*; it looked to an isolated part of, rather than to the overall import of the entire transaction from beginning to end.

The lower courts further misapplied the law when they drew the distinction between the stockholder's busi-

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[48] 248 F.2d 399 (CCA 2, 1957).

[49] 57 F.2d 633, 634 (CCA 6th, 1932).

ness purpose, which they acknowledge, and the corporation, which they deny. Where a closely held corporation is involved, it actually matters not whether the business purpose is that of the corporation or the stockholder. The distinction between them has been repudiated by the Tax Court itself and is "unrealistic and impracticable." *Lewis* v. *C.I.R.*[50] There it was insisted that no statutory reorganization took place because the plan had been motivated by a "shareholder purpose" and not a "corporate purpose" as required by *Gregory*. The Tax Court had rejected the distinction, and the Appellate Court affirmed, declaring:

> "At one time in applying the so called 'business purpose' test of the Gregory case, the Tax Court did distinguish between 'shareholder purpose' and 'corporate purpose' in closely held corporations. (citations omitted) We think that the Tax Court has been correctly advised in unequivocally repudicating that distinction here. (citations omitted) To seek to differentiate between 'corporate purpose' and 'shareholder purpose' is unrealistic and impractical, particularly with respect to closely held corporations. (citations omitted) The separate legal identity of these corporations should not obscure the fact that they are operated by their shareholders in a manner thought best calculated to serve the latter's interests. *What is deemed best for the shareholders is deemed best for the corporation, and vice versa.* We think it not insignificant that, in affirming the Bazley and Adams decisions, *the Supreme Court gave no countenance to the distinction petitioners advocate.* (citations omitted) (emphasis added)

So even adopting the Opinion of the Tax Court, that there were no business purposes of Hoover, Inc. exclusively, as distinguished from those of its sole stockholder, there still were good business purposes, which the Tax

[50] 176 F.2d 646, 649 (CCA 1, 1949).

Court recognized. The lower courts having made these findings of fact have improperly applied the law because their conclusions denying a loss to the Petitioner clearly conflict with the decisions of this Court and the other Circuit Courts.

This Court has granted the writ of certiorari when decisions of the lower courts were in conflict with this Court's decisions. *Parsons* v. *Smith, supra.* Also, this Court has reviewed when the lower court decision conflicts with the decisions in other Circuit Courts, *U.S.* v. *Donruss Co.*,[51] *U.S.* v. *Correll*,[52] *Equitable Life Assurance Society* v. *C.I.R.*[53]

The misapplication of *Gregory, Court Holding, Higgins* and *Minnesota Tea, supra,* by the lower courts is an absolute departure from the principles set forth in these cases by this Court. Likewise, the lower courts' decisions are in conflict with the Circuit Courts who have construed the *Gregory* line of cases. Clearly review is necessary for a uniform application of the Internal Revenue Laws.

III

AS A MATTER OF LAW, IS A TRANSFER FROM THE SOLE STOCKHOLDER TO THE CORPORATION A BONAFIDE INDEBTEDNESS WHEN THE LEGAL CRITERIA SET FORTH IN THE STATUTE AND CASE LAW ESTABLISHES A LOAN?

On December 29, 1966, E. H. Hoover, Jr. loaned to Petitioner $594,000.00. The Tax Court having concluded that the transfer of funds from E. H. Hoover, Jr. to Petitioner, to Burns, Inc., to the Bank was without legiti-

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[51] 393 U.S. 297 (1968).

[52] 389 U.S. 299 (1967).

[53] 321 U.S. 560 (1944).

mate business purpose, denied that a bonafide indebtedness was created. The undisputed facts in the record show that the transfer from E. H. Hoover, Jr. to Petitioner met the legal criteria to establish a loan.

The Tax Court and Court of Appeals ignored the legal criteria necessary to establish a loan as set forth in the tax cases. See, e.g., *Harlan* v. *U.S.*,[54] *Tomlinson* v. *1661 Corporation*,[55] *Smith* v. *C.I.R.*[56] and *Santa Anita Consolidated, Inc.* v. *Commissioner, supra.*

Under the criteria of those cases, factors to consider in examining each unique fact situation in determining whether there is a loan include—an unconditional and unsubordinated obligation to repay—a note with a fixed rate of interest—book entries—interest paid and reported on tax returns—no voting rights—repayment on principal—a borrower with substantial net worth, rather than a new, expending and under-capitalized business—logical business good sense in doing what was done the way it was done—the stated, obvious and only logical intent of the lender. Here all of these factors lead to the same answer, i.e., a bona fide loan. Indeed, a most persuasive confirmation that there was a loan is the Tax Court's own erroneous condemnation of E. H. Hoover, Jr. having a solvent debtor, rather than suffering the loss himself.

In short, the advance was a loan, and the interest expense is deductible as such under Section 163(a) of the Code, that provides:

> "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

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[54] 409 F.2d 904 (CCA 5, 1969).

[55] 337 F.2d 291 (CCA 5, 1967).

[56] 370 F.2d 178 (CCCA 6, 1966).

Clearly the lower courts decided the indebtedness question in a way in conflict with the decisions of other Courts of Appeals on the same matter and their decision should be reviewed under the authority of *U. S.* v. *Donruss, supra, U.S.* v. *Correll, supra,* and *Equitable Life Assurance Society* v. *C.I.R., supra.*

CONCLUSION

For the reasons herein set forth, it is respectfully prayed that a Writ of Certiorari be granted to review the Order of the United States Court of Appeals for the Sixth Circuit and the Opinion and Decision of the United States Tax Court.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

No. 72-1775

[Filed Feb. 27, 1973, James A. Higgins, Clerk]

HOOVER, INC.,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

ORDER

Before: PECK and KENT, Circuit Judges, and YOUNG, District Judge.*

This is an appeal from the Tax Court's holding that the appellant in substance acted merely as a conduit by which its controlling shareholder, as guarantor of a loan, paid the debt owed by John L. Burns, Inc. to a bank, and, therefore, the appellant taxpayer was not entitled to any deduction arising out of the transaction. Clearly, our review of tax court decisions is the same as the standard applied in the review of District Court decisions. *Kunz* v. *C.I.R.*, 333 F.2d 556 (6th Cir. 1964). In its opinion (T.C. Memo. 1972-54), the Tax Court stated:

> "Also, petitioner and Hot Mix, both wholly owned by Hoover, were guarantors of this debt [the debt which gave rise to the claimed deductions]."

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* Honorable Don J. Young, United States District Judge for the Northern District of Ohio, sitting by designation.

To this extent the Tax Court's opinion is clearly erroneous. It appears affirmatively that the petitioner-appellant was not a guarantor of the debt in question. In all other respects we conclude that we cannot find the Tax Court's findings of fact to be clearly erroneous. The law was properly applied.

Now, therefore, IT IS ORDERED that the decision of the Tax Court be and it is hereby affirmed.

ENTERED BY ORDER OF THE COURT

/s/ James A. Higgins
Clerk

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE SIXTH COURT

Docket No. 72-1775

[Filed Mar. 26, 1973, James A. Higgins, Clerk]

HOOVER, INC.,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

MOTION FOR STAY OF MANDATE

Comes Hoover, Inc., the Petitioner and Appellant, and moves the Court for a Stay of Mandate on the grounds that it is preparing a Petition for Writ of Certiorari to be filed in the United States Supreme Court.

Respectfully submitted,

JAMES CLARENCE EVANS
CHARLES CARTER BAKER, JR.

By /s/ Charles Carter Baker, Jr.

[Stay for 60 days granted /s/ W. W. K.]

CERTIFICATE OF SERVICE

It is hereby certified that service of the foregoing Motion has been made upon opposing counsel this 21st day of March, 1973, by mailing a copy thereof in an envelope, postage prepaid, properly addressed as follows:

Mr. Richard Farber
% Meyer Rothwacks
Tax Division
United States Department of Justice
Washington, D. C. 20530

/s/ Charles Carter Baker, Jr.
CHARLES CARTER BAKER, JR.
Attorney for Petitioner-Appellant

APPENDIX C

UNITED STATES TAX COURT

Docket No. 6156-69

HOOVER, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

T. C. MEMO. 1972-54

(Filed February 28, 1972)

E. H. Hoover, Jr. owned all the stock of petitioner, a supplier of stone for road builders, and of Hot Mix, Inc., a corporation engaged in road construction. Burns, Inc., a subsidiary of Hot Mix, was indebted to a bank for $594,000 and was insolvent. The bank was insured by F & C. Hoover, petitioner and others guaranteed F & C against loss and Hoover deposited collateral with F & C. In December 1966 demand was made on Hoover, individually, that he make good on his guaranty. He authorized F & C to liquidate the deposited collateral. F & C did so and made the proceeds available to Hoover, who delivered his check for $594,000 to petitioner in exchange for its note. Petitioner delivered its check to Burns, Inc. and received its note. Burns, Inc. paid the debt.

Petitioner was a mere conduit through which Hoover met his obligation as guarantor of the debt of Burns, Inc., and these transactions gave rise to no true debtor-creditor relationship between petitioner and Burns, Inc.

Held: Petitioner is not entitled to a deduction by reason of these transactions either as a bad debt, a business loss, or an ordinary and necessary business expense, and is not entitled to loss carrybacks to prior years, nor an interest deduction for 1967.

James Clarence Evans and *Charles Carter Baker, Jr.*, for the petitioner.

Jack D. Yarbrough, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

BRUCE, *Judge:* Respondent determined deficiencies in income tax of the petitioner and additions to tax under section 6653(a) of the Internal Revenue Code of 1954 for the years and in the amounts as follows:

Taxable Year	Deficiency	Addition to Tax Sec. 6653(a)
1963	$20,938.94	—
1964	57,076.32	$2,853.82
1965	80,653.98	4,032.70
1966	32,360.33	1,618.02
1967	11,241.48	—

At the trial of this case respondent conceded that petitioner was not liable for the additions to tax under section 6653(a). Respondent also concedes that petitioner is entitled to a deduction of $2,644.39 for the taxable year 1967 for depreciation on the buildings and equipment transferred from John L. Burns, Inc. to petitioner.

The principal issue before the Court is whether petitioner is entitled for the taxable year 1966 to a deduction of $557,746.07 for an advance made to John L. Burns, Inc., either as a bad debt, a business expense, or an ordinary business loss. The remaining issues are: (a) whether petitioner is entitled for the taxable year 1967 to a deduction of $33,304.12 for accrued interest allegedly owed to E. H. Hoover, Jr.; (b) whether petitioner is entitled to net operating loss deductions for the taxable years 1963, 1964, and 1965, resulting from carrybacks of a claimed net operating loss for the taxable year 1966. These last two issues will be determined by the outcome of the principal issue involved.

FINDINGS OF FACT

Petitioner is a Tennessee corporation which, at the time of the filing of the petition herein, had its principal office at Donelson, Davidson County, Tennessee. As its primary business, at least since 1960, petitioner has been engaged in quarrying and selling limestone and related products for use in highway and other construction. Petitioner maintains its records and files its Federal income tax returns on the accrual method of accounting. It filed its Federal income tax returns, Forms 1120, for the calendar years 1962 through 1967 with the district director of internal revenue at Nashville, Tennessee, or the director of the Southeast Service Center, Chamblee, Georgia. All of the capital stock of petitioner has, since May 1960, been owned by E. H. Hoover, Jr. (sometimes hereinafter referred to as Hoover). He was president of the corporation for the years 1962 through 1967.

Hot Mix, Inc. is a Tennessee corporation which has been engaged in the business of supplying paving materials and services used for road and highway construction since 1960. It engaged in business as a general contractor and held general contractors' licenses.

In December, 1964, Hoover owned 35 percent of the outstanding stock of Hot Mix, Inc.; on July 31, 1965, he owned 50 percent of such stock; and in July, 1966, he acquired the remaining capital stock. In July 1964, Hot Mix, Inc., acquired as wholly-owned subsidiaries, the following listed Tennessee corporations:

John L. Burns, Inc.
Supplies, Inc.
Burns Equipment Company, Inc.
Concrete, Inc.

John L. Burns, Inc. (Burns, Inc.) is a Tennessee corporation which has been engaged in business as a general

contractor, primarily in road grading and general highway construction, and held general contractors' licenses issued by the State of Tennessee.

The principal business of Burns Equipment Company, Inc. (Equipment), was to rent equipment to Burns, Inc., which the latter operated and used in its business. Burns, Inc., however, owned and operated a substantial amount of equipment. The principal business of Concrete, Inc. was concrete construction. This corporation constructed concrete bridges, did concrete work and poured concrete paving. The principal business of Supplies, Inc. was to sell incidental supplies to the contracting industry.

The petitioner's taxable income (loss), Federal income tax liability and accumulated earned surplus for its taxable years 1962 through 1966 are shown below:

Years	Taxable Income (loss)	Income Tax Liability	Accumulated Earned Surplus
1962	$ 45,433*	$ 10,259	$110,350
1963	77,817	20,949	223,936
1964	143,921	53,376	432,553
1965	484,599	202,993	868,758
1966	(386,645)**	None **	719,171**

* After net operating loss deduction of $26,672.17.

** After deductions of "bad debt" of $555,746.07 which is in issue.

The taxable income (loss), Federal income tax liability, and accumulated earned surplus of Equipment, for the years indicated, are shown in the following tabulation (cents omitted):

Fiscal Year	Taxable Income	Income Tax Liability	Accumulated Earned Surplus
2-28-62	($ 3,965)	None	$ 77,279
2-28-63	(5,074)	None	79,579
2-29-64	(55,650)	None	24,496
11-30-64	104,110	$46,805	118,485

The taxable income (loss), Federal income tax liability, and accumulated earned surplus (deficit), of Burns, Inc., for the years indicated are shown in the following tabulation (cents omitted):

Fiscal Year	Taxable Income	Income Tax Liability	Accumulated Earned Surplus
1-31-63	$ 38,531*	$13,631	$76,464
1-31-64	(43,834)	None	(79,491)
11-30-64	(222,879)	None	31,859

* After net operating loss deduction of $6,607.

The taxable income (loss), Federal income tax liability and accumulated earned surplus (deficit) of Concrete, Inc., for the years indicated are shown in the following schedule (cents omitted):

Fiscal Year	Taxable Income	Income Tax Liability	Accumulated Earned Surplus
8-31-61	None	None	None
8-31-62	($10,848)	None	($ 10,848)
8-31-63	None	None	(10,848)
11-30-64	(47,853)	None	(153,702)

The taxable income, Federal income tax liability and accumulated earned surplus of Hot Mix, Inc., for the indicated years are shown in the following tabulation (cents omitted):

Fiscal Year	Taxable Income	Income Tax Liability	Accumulated Earned Surplus
7-31-61	$18,241	$ 5,472	$12,768
7-31-62	24,550	7,365	29,954
7-31-63	30,640	9,283	50,021
7-31-64	38,690	10,950	74,382

Hot Mix, Inc. and its subsidiaries, Burns, Inc., Concrete, Inc., Supplies, Inc., and Equipment, filed consoli-

dated Federal income tax returns for the fiscal years ended July 31, 1965, 1966, and 1967. These returns reflected consolidated losses in the amounts of $4,600.12, $286,726.80, and $26,418.83, for the fiscal years 1965, 1966 and 1967, respectively, and, no income tax liability for any of these years. The taxable income or (loss) for each of these corporations as shown in these returns is as follows:

Taxable Income (loss) (cents omitted)

Fiscal Year	Hot Mix, Inc.	Burns, Inc.	Concrete, Inc.	Supplies, Inc.	Equipment
1965	$560,953	($425,436)	($141,776)	None*	$1,659
1966	30,686	(282,562)	(33,300)	None*	1,550
1967	75,427	(99,056)	None*	($2,790)	None*

* After net operating loss deductions.

The earned surplus (deficit) of Hot Mix, Inc. and its subsidiaries as reflected in the Federal consolidated income tax returns for the fiscal years ended July 31, 1965, 1966 and 1967, is as follows (cents omitted):

Fiscal Year	Hot Mix, Inc.	Burns, Inc.	Concrete, Inc.	Supplies, Inc.	Equipment
1965	$639,830	($395,398)	($300,479)	($ 97,772)	$120,145
1966	642,044	(676,186)	(333,779)	(97,513)	118,594
1967	701,555	(775,242)	(296,442)	(100,303)	125,303

The petitioner, Hot Mix, Inc. and Burns, Inc. have from time to time participated in highway construction contracts involving on one project the services and products of two or three of these businesses. The interrelation of these corporations has enabled them to offer general contracting services, subcontracting services, and the supplying of material, and to bid on and participate in highway contracts more advantageously than any of them could do alone. The petitioner acted only as a supplier and not as

contractor or subcontractor on highway projects. In this capacity it was not subject to governmental restrictions and the wage scales imposed under Federal law.

Petitioner, by having available a paving contractor, Hot Mix, with which jointly to negotiate "package" proposals, has had an advantage in securing stone and aggregate sales to independent general and subcontractors on interstate highway projects in Tennessee, Georgia, Alabama and Kentucky, and on various other roadway construction jobs. Petitioner would require that its stone must be used if Hot Mix were permitted to participate. When a job was bid and a contract obtained by the prime or subcontractor member of the team, petitioner would then bring in its equipment for opening a limestone quarry and crushing the product for sale to Burns, Inc. or Hot Mix. As a result of having a quarry established in a particular construction area, the team could bid competitively on subsequent contracts in the area and petitioner, as supplier, and Hot Mix, acting as a paving subcontractor, could sell their product and services even if the team was not successful in bidding as the prime contractor.

On January 5, 1961, a contract was executed between Burns, Inc. and the State of Georgia whereby Burns, Inc. as general contractor, agreed to furnish labor and material to do certain work on Interstate Highway Project No. I-75-3, Contract 1, in Whitfield County and Catoosa County, Georgia. When this contract was bid Hoover and his associates planned that petitioner would sell the crushed stone and aggregate to be used on the project to Burns, Inc., and Hot Mix was to perform the paving on a subcontract from Burns, Inc. Although the team comprised of Burns, Inc., Hox Mix and petitioner worked together in submitting the bid through Burns, Inc., and petitioner opened a quarry for the job, petitioner subsequently contracted the stone supply to a local material supplier that had already established an operating quarry.

After work was begun on the Georgia project, Burns, Inc. had difficulty in meeting its contract commitments and subsequently suffered financial losses on the project. For the taxable year beginning February 1, 1962, Burns, Inc. had retained earnings of $178,884 that declined to $76,464 in that year and declined further in 1963 to a deficit of $79,491 as of January 31, 1964. Nine months later Burns, Inc.'s earned surplus as of November 30, 1964 was $31,859.

The Fidelity & Casualty Company of New York (Fidelity), as surety, furnished bid and performance bonds necessary for Burns, Inc., Hot Mix and petitioner to bid and perform highway construction jobs. After Burns, Inc. began having financial difficulty, Fidelity gave its guarantee to the Commerce Union Bank of Nashville (Bank), in order to obtain for Burns, Inc. and Hot Mix a $600,000 line of credit. Pursuant to the terms of the guarantee Burns, Inc. and Hot Mix were required to deposit the funds from the bank loans in a joint-control account with disbursals permitted only on joint signatures, including an agent of Fidelity. On October 2, 1963, the Bank, as a requisite to granting the line of credit up to $600,000 for Burns, Inc. and Hot Mix, required Burns, Inc., Hot Mix, Equipment, Supplies, Concrete, John L. Burns and E. H. Hoover, Jr. to execute a guaranty pursuant to which they guaranteed payment to the Bank of the loans made under the line of credit. As security for the guaranty, all of the capital stock of the above corporations and of petitioner was to be deposited with the Bank as collateral; Burns, Inc., Equipment, and Supplies were to execute a chattel mortgage agreement on all their machinery and equipment in favor of the Bank and Burns, Inc. and Hot Mix were to execute assignments upon their accounts receivable, including any retainages thereon, and pay the proceeds when received to the general control account of Hot Mix and Burns, Inc., which was to be supervised by Fidelity.

The guarantee provided in paragraph 7 thereof, as follows:

> It is expected that The Fidelity and Casualty Company of New York will obtain an instrument of Guaranty from John L. Burns, Inc., Hot Mix, Inc., John L. Burns and Eph Hoover, Jr. to guarantee the repayment of any loans made within the aforementioned Six Hundred Thousand Dollars ($600,000.00) line of credit. Further other types of collateral security will be obtained in the form of chattel mortgage on road construction and miscellaneous equipment and capital stock in various corporations. All will be obtained in the name of the Commerce Union Bank or in blank and delivered to said Bank. It is understood that said security and/or guaranty will be assigned to The Fidelity and Casualty Company of New York in the event payment is made by The Fidelity and Casualty Company of New York under this guaranty.

On December 12, 1963, Burns, Inc. and Hot Mix, as principals, and petitioner, as indeminitor, entered into a "General Contract of Indemnity" under which they agreed to indemnify Fidelity against any loss resulting from liability on any surety bond which Fidelity might sustain as surety on behalf of either of the principals.

In June 1964, Hot Mix and Burns, Inc. were submitting to the State of Tennessee, Highway Department, three bids as prime contract bidders, in the total amount of approximately $2,500,000, and on June 26, 1964, an agreement was entered into between Fidelity and Hot Mix and Burns, Inc., under which Fidelity, as surety, would issue bid bonds for Hot Mix and Burns, Inc. as principals, and performance bonds in the event of the award or awards of any contract or contracts. Fidelity also agreed to obtain for Hot Mix and Burns, Inc. a line of credit totaling $200,000. The terms of the earlier agreement under which the previous $600,000 line of credit had been ob-

tained at the Bank were incorporated by reference in the agreement. This agreement was also executed by Equipment, Supplies, Inc., Concrete, Inc., and John L. Burns and E. H. Hoover, Jr., as individuals.

At some time prior to June 1964, Hoover had sold certain stock in a corporation known as Hoover Motor Express, Inc. to Ryder Systems, Inc. The purchaser had deposited in escrow with The First American National Bank of Nashville the sum of one million dollars, and a further sum was to be paid in the future at the closing of the sale. In the agreement with Fidelity under date of June 26, 1964, Hoover also pledged and assigned the deposited funds, and other amounts due from Ryder, to the extent of $800,000 in all, as additional security to Fidelity.

Burns, Inc. had ceased to perform any construction work shortly before March 8, 1965. It had completed most of its work on the Whitfield-Catoosa contract in Georgia.

On March 8, 1965, all of the operating equipment owned by Burns, Inc. was sold at public auction in Nashville, Tennessee, for $634,695. From these proceeds the auctioneers received $34,678.62 for commission; a finance company received $33,908.47; a machine company received $436,665.18; and Burns, Inc. received the balance of $129,442.73. It was generally known in the road construction industry that Burns, Inc. was inactive and out of business at the time of the auction sale. The sale was widely advertised Burns, Inc. used the proceeds it received from the auction sale to pay for supplies and other bills. The income and expenses of Burns, Inc. after March 8, 1965, related to work performed by subcontractors on the Whitfield-Catoosa contract and a Giles County, Tennessee, job.

On April 13, 1966, a "General Contract of Indemnity" was entered into by Burns, Inc., as principal, and Hot

Mix, Equipment, Concrete, Inc. and petitioner, as indemnitors, and the Continental Insurance Company (an affiliated company of Fidelity) providing that the indemnitors would indemnify Continental in the event of any claims or other losses which that company might sustain as surety on behalf of the principal. On the same date another "General Contract of Indemnity" was entered into by Hot Mix, as principal, and Burns, Inc., Equipment, Concrete, and petitioner, as indemnitors, and Continental, in the same form and language.

Burns, Inc. borrowed a total of $700,000 from the Commerce Union Bank under the lines of credit extended to it and Hot Mix. These loans were evidenced by five promissory notes, payable on demand, signed between October 3, 1963, and July 8, 1964. The amount owed to the Bank by Burns, Inc. on these notes on December 1, 1966, was $594,000.

In November of 1966 a representative of Fidelity discussed with Hoover the problem of securing payment of the debt of Burns, Inc. to the Bank.

On December 1, Fidelity wrote Hoover, personally, as follows:

> As you know, The Fidelity and Cacualty Company of New York arranged for certain Lines of Credit on behalf of Hot Mix, Inc. and John L. Burns, Inc. with Commerce Union Bank of Nashville, Tennessee (hereafter Commerce Union) in the respective amounts of $600,000. and $200,000. As an inducement to Commerce Union to extend these Lines of Credit The Fidelity and Casualty Company of New York guaranteed repayment of any loans to Hot Mix, Inc. and John L. Burns, Inc. thereunder. As of this time and under said Lines of Credit Hot Mix, Inc. and John L. Burns, Inc. are obligated to Commerce Union in the amount of $594,000.

> Contemporaneously with the establishment of these Lines of Credit you joined with Hot Mix, Inc., John L. Burns, Inc. and others to guarantee repayment of the aforementioned loan.
>
> Demand is made upon you to meet your obligation under this guarantee. You are requested to make immediate arrangements for the repayment of Commerce Union in the amount of $594,000. to the end that The Fidelity and Casualty Company of New York will not be required to respond under its guarantee, and, further, that the Fidelity and Casualty Company of New York will be released forthwith from any and all obligations it may presently or hereafter have to Commerce Union under said guarantee.

In a letter to Fidelity dated December 5, 1966, Hoover replied:

> I refer to your demand letter of December 1st relative to the obligation of Hot Mix, Inc. and John L. Burns, Inc. to Commerce Union Bank of Nashville, Tennessee in the amount of $594,000., said obligation being subject to my guarantee.
>
> I have heretofore caused certain collateral to be deposited with you to secure you against exposure in connection with the above. I hereby request that you apply such collateral to the satisfaction of the above obligation.
>
> In complying with this request you may take such steps as you deem advisable in your judgment to protect the interests of The Fidelity and Casualty Company of New York.
>
> Since said collateral is in the form of both cash and United States Government Securities you are authorized to liquidate such securities at your convenience in order to effectuate the above.

Pursuant to Hoover's instructions of December 5, 1966, Fidelity liquidated Hoover's collateral. At some time there-

after and on or before December 29, 1966, Fidelity made the proceeds available to Hoover.

On December 29, 1966, the following transactions were carried out:

(1) Hoover, individually and as an officer of petitioner, and C. R. Mackay, as an officer of Burns, Inc., Hot Mix, Equipment, Supplies, and Concrete, signed a document entitled "Supplemental Conditions and Provisions," which stated, in part:

> WHEREAS, The Fidelity and Casualty Company of New York (hereafter F & C) has demanded of Eph Hoover, Jr. (hereafter Hoover) to satisfy a loan at Commerce Union Bank guaranteed by F & C and Hoover wishes to satisfy said loan, and
>
> WHEREAS, Hoover, as assignor, did under date of June 29, 1964, irrevocably transfer, set over and assign to F & C his interest, up to Eight Hundred Thousand ($800,000) Dollars, in the proceeds of the sale of certain stock of Hoover Motor Truck Lines, Inc. to Ryder Systems, Inc. such having then been paid to First American National Bank (of Nashville, Tennessee), as escrow agent, or still to be paid by Ryder Systems, Inc. (all as more fully outlined in a copy of said assignment attached hereto), and
>
> WHEREAS, under date of June 29, 1964, said Hoover and F & C did enter into a certain contract entitled CONDITIONS AND PROVISIONS providing, among other things, that F & C was to retain the funds received under the aforementioned assignment until designated obligations of John L. Burns, Inc. and/or Hot Mix, Inc. under certain contracts and surety bonds and certain obligations to Commerce

Union Bank, Nashville, Tennessee, such having been guaranteed by F & C, were fully performed and satisfied, and

WHEREAS, First American National Bank did on April 2, 1965, as provided in said assignment, pay to F & C the sum of Five Hundred Ninety Thousand ($590,000) Dollars which F & C presently retains as provided in said CONDITIONS AND PROVISIONS, plus interest less certain payments to Hoover, and

WHERAS, Hoover wishes to see the obligation to Commerce Union Bank satisfied from the funds received and retained by F & C and has by letter requested that F & C arrange for said payment from said funds.

NOW, THEREFORE, in consideration of F & C acting on said request of Hoover, it being understood that F & C may act in a manner that will best protect its interests, Hoover agrees as follows:

1. That the assignment heretofore mentioned, and which has been filed with and acknowledged by Ryder Systems, Inc. and First American National Bank will remain in full force and effect.

2. That F & C may retain such sums as it may hereafter receive under said assignment, up to Two Hundred Thousand ($200,000) Dollars, pending the full completion by John L. Burns, Inc. and/or Hot Mix, Inc. of all contracts bonded by F & C and their acceptance and until all bills accruing thereon to materialmen, laborers and subcontractors are paid and the obligations of F & C under said bonds are extinguished.

3. That in the event F & C is required to respond under the terms of any bond issue for John L. Burns,

Inc. and/or Hot Mix, Inc. or should F & C incur any loss or expense in connection therewith, F & C shall be entitled to be made whole and to retain and apply against such loss and expense all or any part of said funds.

* * * *

(2) Hoover gave his personal check to petitioner in the amount of $594,000;

(3) Petitioner advanced $594,000 to Burns, Inc. by certified check. Burns, Inc. deposited this check in its account at the Commerce Union Bank on the same date;

(4) Bruns, Inc. issued its check to the Bank for $594,-000 in payment of the five outstanding notes owed to the Bank. Each of these notes bears the stamp of the "note teller" of the Bank, reflecting they were paid on December 29, 1966;

(5) E. H. Hoover, Jr. received a demand promissory note from petitioner dated December 29, 1966, payable to him in the amount of $594,000, with interest at 5 percent per annum;

(6) Petitioner recevied a demand promissory note from Burns, Inc. dated December 29, 1966, in the amount of $594,000 with interest at 5 percent per annum.

When petitioner made the advance to Burns, Inc., the latter had contingent claims against the State of Georgia and a subcontractor arising from the I-75 Highway Project in Whitfield and Catoosa counties, Georgia. Burns, Inc. collected nothing on either of the claims prior to December 1970.

As of December 31, 1966, the petitioner's records reflect that it charged off as a bad debt the sum of $557,746.07 representing the balance due on the advance of $594,000

after crediting Burns, Inc. with the transfer of land, buildings, and furniture at book value to petitioner. At the end of the year 1966, Hoover believed that Burns, Inc. would never be able to pay petitioner the funds it had advanced on December 29, 1966. There were no changes in the circumstances of Burns, Inc. between December 29, 1966 and December 31, 1966.

Petitioner accrued and deducted as interest payable to E. H. Hoover, Jr. for the taxable year 1967 the amount of $33,304.12 with respect to his advance of $594,000. Petitioner made further payments to Hoover of $29,640 as interest on his advance on December 31, 1968, and $29,640 on December 30, 1969. Petitioner also paid Hoover $100,000 on August 11, 1967, which was treated on its books as a repayment of principal on his $594,000 advance.

In the statutory notice of deficiency for the taxable year 1966, respondent disallowed a deduction claimed for bad debts to the extent of $557,746.07, stating:

> because it is determined that this amount, $557,746.07, resulting from the transfer of funds to John L. Burns, Inc., a controlled corporation, is not allowable under section 166 of the Internal Revenue Code as it has not been established that a debtor-creditor relationship existed or was intended by the transfer,
> * * *

The substance of the transaction outlined herein was that E. H. Hoover, Jr. paid the debt that Burns, Inc. owed the Bank. Petitioner was merely a conduit and no bona fide debtor-creditor relationship was created between petitioner and Burns, Inc., or between petitioner and Hoover, by means of the transfers of funds from Hoover to petitioner and from petitioner to Burns, Inc.

The accrual and payment of $33,304.12 by petitioner to Hoover was not a payment of interest deductible by peti-

tioner as an ordinary and necessary expense for the taxable year 1967.

Petitioner is not entitled to deductions for net operating losses for the taxable years 1963, 1964 and 1965, resulting from carrybacks of a net operating loss for 1966.

OPINION

The petitioner claimed a deduction as a bad debt on its corporation income tax return for 1966 for the amount of $557,746.07 as representing a transfer to John L. Burns, Inc. of $594,000 less an amount for land, buildings and furniture transferred to it from Burns, Inc. Petitioner contends that the amount is properly deductible either as a bad debt under section 166, a loss under section 165, or an ordinary and necessary business expense under section 162(a), Internal Revenue Code of 1954.[1] Respondent denied the deduction as claimed and contends that the amount is not allowable as a deduction under any provision of law.

Petitioner was wholly owned by E. H. Hoover, Jr. In December 1966 the Fidelity and Casualty Company of

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[1] SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *

* * * *

SEC. 165. LOSSES.

(a) General rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * * *

SEC. 166. BAD DEBTS.

(a) General Rule.—

(1) Wholly Worthless Debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

* * * *

New York demanded of Hoover personally that he meet his obligation under his guarantee for repayment of a loan made by Commerce Union Bank of Nashville to John L. Burns, Inc., and insured by Fidelity, in the amount of $594,000. The method adopted by Hoover to comply with this demand gave rise to the present controversy.

Hoover had previously assigned to Fidelity as collateral security certain funds on deposit in another bank, some of which were invested in Government securities. At Hoover's request, Fidelity liquidated this collateral and made the proceeds available to him. Hoover then gave his personal check for $594,000 to petitioner and took petitioner's note for this amount. Petitioner delivered its check in this amount to Burns, Inc. and received that corporation's note. Burns, Inc., which was otherwise insolvent, paid its obligation to the bank from this source.

E. H. Hoover, Jr. was personally a guarantor of the liability of Burns, Inc. Also, petitioner and Hot Mix, both wholly owned by Hoover, were guarantors of this debt. Burns, Inc. was a subsidiary of Hot Mix.

Petitioner had operated at a profit in the years 1962 through 1965 and had a profit from its operations in 1966 prior to this transaction. Hot Mix and its subsidiaries had filed consolidated returns for fiscal years ended July 31, in 1965 and 1966, reporting losses, principally due to losses incurred by Burns, Inc.

Petitioner's reply brief states in part "* * * it would hardly have made sense for any controlling stockholder in Mr. Hoover's situation to have let his personal $594,000 go to the insolvent John L. Burns, Inc., with no hope of recovery, rather than to insist that the business team in some way incur the business loss and that he loan his money to a solvent creditor [debtor]. * * * He was faced with the choice of losing his own $594,000 or letting petitioner, which was the company directly making the profits

from the stone sales through the team, and which was obligated as he was, bear the loss."

E. H. Hoover, Jr. provided the funds for payment of the debt of Burns, Inc. to the bank. He chose to transmit the funds through petitioner's accounts. It is the position of the petitioner that Hoover may do this in order to let petitioner, rather than Hoover, personally, bear the loss on the worthless debt of Burns, Inc.

It is contended that petitioner had good and sufficient reasons for paying the debt of Burns, Inc. It was an indemnitor of Burns, Inc. under certain contracts with Fidelity and Continental. It was expecting to continue in business as a supplier to Hot Mix in future contracts of that corporation. Burns, Inc. had been associated with petitioner in earlier contracts and it was desirable to preserve the reputation of the "team" and its members for payment of debts when new bids were made or bonds were sought. Hence, petitioner paid to protect its credit rating and ability to secure bonds in the future.

The demand made by Fidelity for payment of the debt of Burns, Inc. to the bank was made upon E. H. Hoover, Jr., personally, and not upon petitioner. Fidelity held a substantial amount of Hoover's personal funds under an absolute assignment. While Fidelity permitted Hoover to transfer these funds through petitioner's accounts in the process of paying the bank, petitioner was nothing more than a conduit for this transfer to serve Hoover's private purpose and for his personal benefit.

The only party to derive a benefit from the method in which the obligation of Burns, Inc. was paid was Hoover, personally. By transmitting the funds through the petitioner corporation as a conduit, an opportunity was provided for petitioner to claim a deduction from its taxable income for 1966 sufficient to create a net operating loss, with carrybacks to prior profitable years. Also, Hoover

was afforded a source of repayment of the funds demanded of him by Fidelity under his personal guaranty. Petitioner, having operated at a profit, was the only corporation in the group which could get a material tax benefit from claiming such a deduction, and might eventually be able to reimburse Hoover out of future earnings for the payment made on account of his guaranty. And if his corporation could be saddled with the realized loss, Hoover would not have to bear it personally.

Petitioner was not called upon by the bank or by Fidelity to pay the debt, as indemnitor or otherwise. Transmission of the funds used for payment through petitioner was not a necessary step in accomplishing payment to the bank. Hoover, as controlling stockholder, desired that petitioner bear the loss. Petitioner received the worthless note of the insolvent Burns, Inc. and gave Hoover petitioner's note which petitioner had sufficient assets to cover. This is a manipulation of a controlled corporation for the personal benefit of the controlling stockholder. It is inconceivable that had petitioner been free to choose, it would voluntarily have assumed this loss to its own detriment.

It is well established that tax consequences must turn on the economic substance and not the form of the transaction in issue. *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945); *Gregory* v. *Helvering*, 293 U.S. 465 (1935); *Higgins* v. *Smith*, 308 U.S. 473 (1940). As stated in *Commissioner* v. *Court Holding Co., supra:*

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. *A sale by one person cannot be transformed*

for tax purposes into a sale by another by using the latter as a conduit through which to pass title. * * * [Emphasis supplied.]

Although the *Court Holding Company* case dealt with a sale, the principle expressed therein has been applied to federal taxing statutes in general. *Higgins* v. *Smith, supra; Gregory* v. *Helvering, supra.* A given result at the end of a straight path is not made a different result because reached by following a devious path. *Minnesota Tea Co.* v. *Helvering,* 302 U.S. 609 (1938).

Petitioner's argument that it advanced this money in order to protect its future business is without merit. Any conceivable benefit to the petitioner's business is speculative and peripheral and is insufficient to justify the voluntary assumption of a loss of the magnitude here involved. There is nothing in the record to indicate the loan had to be repaid by petitioner rather than by Hoover personally.

The petitioner has not shown a sound business purpose in carrying out the transcation in the manner actually employed. An operation having no business purpose other than to minimize taxes will not be recognized. *Gregory* v. *Helvering, supra.* It was there argued that the action taken was a reorganization pursuant to the statute, and the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows. The court said the undertaking was "an elaborate and devious form of conveyance masquerading as a corporate reorganization" and affirmed the decision that there had been no "reorganization" within the statute.

A transaction should not be given effect for tax purposes unless it serves a purpose other than tax avoidance. Having the petitioner in form pay the loss with funds supplied by Hoover was a mere formalism designed to

alter the tax liabilities resulting from the settlement. *Gregory* v. *Helvering*, *supra*.

In our opinion the transfer of Hoover's funds through petitioner's accounts in paying the debt of Burns, Inc. to the bank was a transaction without a legitimate business purpose; petitioner did not become indebted to Hoover thereby; did not acquire a worthless debt from Burns, Inc.; and did not sustain the loss for which the deduction was claimed.

We hold that the petitioner is not entitled to the deduction claimed. The amount was transferred through petitioner as a conduit and no real debtor-creditor relationship between petitioner and Burns, Inc. resulted. By paying, in form, an amount to an insolvent corporation with no reasonable expectation of repayment, petitioner did not acquire a debt from Burns, Inc., and may not deduct the amount under section 166 as a bad debt. Petitioner may not deduct the amount under section 165 as a loss since petitioner had no valid business purpose for the transaction. See *International Trading Co.*, 57 T.C. —— (Dec. 28, 1971). *Richard R. Riss, Sr.*, 57 T.C. —— (Dec. 30, 1971). Petitioner may not deduct the amount under section 162(a) as an ordinary and necessary business expense in the absence of a business purpose of its own rather than of its controlling stockholder.

Since petitioner did not sustain the loss, it is not entitled to the loss carrybacks claimed for 1963, 1964 and 1965. Also, since petitioner did not become indebted to Hoover personally it is not entitled to the deduction claimed for 1967 for interest paid him on the alleged loan.

Decision will be entered under Rule 50.

APPENDIX D

UNITED STATES TAX COURT

Docket No. 6156-69

HOOVER, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the opinion of the Court filed February 28, 1972, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there are deficiencies in income taxes due from the petitioner for the taxable years 1963, 1964, 1965, 1966, and 1967 in the amounts of $20,938.94, $57,076.32, $80,653.98, $32,360.33, and $10,606.82, respectively; and

That there are no additions to the tax due from the petitioner for the taxable years 1964, 1965, and 1966 under the provisions of section 6653(a) of the Internal Revenue Code of 1954.

/s/ J. GREGORY BRUCE
Judge.

Entered April 10, 1972.

(SEAL)

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

/s/ JAMES CLARENCE EVANS,

/s/ CHARLES CARTER BAKER, JR.,
Counsel for Petitioner.

LEE H. HENKEL, JR.,
Acting Chief Counsel,
Internal Revenue Service.

APPENDIX E

LOSSES

Sec. 165 [1954 Code]. (a) GENERAL RULE.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) AMOUNT OF DEDUCTION.—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) LIMITATION ON LOSSES OF INDIVIDUALS.—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100. For purposes of the $100 limitation of the preceding sentence, a husband and wife making a joint return under section 6013 for the taxable year in which the loss is allowed as a deduction shall be treated as one individual. No loss described in this paragraph shall be allowed if, at the time of filing the return, such loss has been claimed for estate tax purposes in the estate tax return.

(d) WAGERING LOSSES.—Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

(e) THEFT LOSSES.—For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

(e) CAPITAL LOSSES.—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) WORTHLESS SECURITIES.—

(1) GENERAL RULE.—If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) SECURITY DEFINED.—For purposes of this subsection, the term "security" means—

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(3) SECURITIES IN AFFILIATED CORPORATION.—For purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset. For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if—

(A) stock possessing at least 80 percent of the voting power of all classes of its stock and at least 80 percent of each class of its nonvoting stock is owned directly by the taxpayer, and

(B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom. As used in subparagraph (A), the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

(h) DISASTER LOSSES.—Notwithstanding the provisions of subsection (a), any loss attributable to a disaster occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief Act of 1970 may, at the election of the taxpayer, be deducted for the taxable year immediately preceding the taxable year in which the disaster occurred. Such deduction shall not be in excess of so much of the loss as would have been deductible in the taxable year in which the casualty occurred, based on facts existing at the date the taxpayer claims the loss. If an election is made under this subsection, the casualty resulting in the loss will be deemed to have occurred in the taxable year for which the deduction is claimed.

(i) CERTAIN PROPERTY CONFISCATED BY THE GOVERNMENT OF CUBA.—

(1) TREATMENT AS SUBSECTION (c)(3) LOSS.—For purposes of this chapter, in the case of an individual who was a citizen of the United States, or a resident alien, on December 31, 1958, any loss of property which—

(A) was sustained by reason of the expropriation, intervention, seizure, or similar taking of the property, before January 1, 1964, by the government of Cuba, any political subdivision thereof, or any agency or instrumentality of the foregoing, and

(B) was not a loss described in paragraph (1) of subsection (c),

shall be treated as a loss to which paragraph (3) of subsection (c) applies. In the case of tangible property, the preceding sentence shall not apply unless the property was held by the taxpayer, and was located in Cuba, on one or more days in the period beginning on December 31, 1958, and ending on May 16, 1959.

(2) SPECIAL RULES.—

(A) For purposes of subsection (a), any loss described in paragraph (1) shall be treated as having been sustained on October 14, 1960, unless it is established that the loss was sustained on some other day.

(B) For purposes of subsection (a), the fair market value of property held by the taxpayer on one or more days during the period beginning on December 31, 1958, and ending on May 16, 1959, to which paragraph (1) applies, on the day on which the loss of such property was sus-

tained, shall be its fair market value on the first day in such period on which the property was held by the taxpayer.

(C) For purposes of section 172, a loss described in paragraph (1) shall not be treated as an expropriation loss within the meaning of section 172(k).

(D) For purposes of section 6601, the amount of any tax imposed by this title shall not be reduced by virtue of this subsection for any period prior to February 26, 1964.

(j) CROSS REFERENCES.—

(1) For special rule for banks with respect to worthless securities, see section 582.

(2) For disallowance of deduction for worthlessness of securities to which subsection (g)(2)(C) applies, if issued by a political party or similar organization, see section 271.

(3) For special rule for losses on stock in a small business investment company, see section 1242.

(4) For special rule for losses of a small business investment company, see section 1243.

(5) For special rule for losses on small business stock, see section 1244.

INTEREST

Sec. 163 [1954 Code]. (a) GENERAL RULE.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

(b) INSTALLMENT PURCHASES WHERE INTEREST CHARGE IS NOT SEPARATELY STATED.—

(1) GENERAL RULE.—If personal property or educational services are purchased under a contract—

(A) which provides that payment of part or all of the purchase price is to be made in installments, and

(B) in which carrying charges are separately stated but the interest charge cannot be ascertained,

then the payments made during the taxable year under the contract shall be treated for purposes of this section as if they included interest equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of the preceding sentence, the average unpaid balance is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12. For purposes of this paragraph, the term "educational services" means any service (including lodging) which is purchased from an educational institution (as defined in section 151 (e)(4)) and which is provided for a student of such institution.

(2) LIMITATION.—In the case of any contract to which paragraph (1) applies, the amount treated as interest for any taxable year shall not exceed the aggregate carrying charges which are properly attributable to such taxable year.

(c) REDEEMABLE GROUND RENTS.—For purposes of this subtitle, any annual or periodic rental under a redeemable ground rent (excluding amounts in redemption thereof) shall be treated as interest on an indebtedness secured by a mortgage.

In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 72-1585

HOOVER, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The United States Tax Court held (Pet. App. C) that petitioner was not entitled to bad debt and interest deductions claimed under Sections 162, 163, 165 and 166 of the Internal Revenue Code of 1954, 26 U.S.C. 162, 163, 165 and 166. The court of appeals affirmed by order (Pet. App. A). Underlying all petitioner's contentions here is its assertion that the Tax Court erred in finding that petitioner made certain payments only as a conduit and not on its own behalf.

1. Petitioner is engaged in quarrying and selling limestone and related products used in building highways. Its sole shareholder is E. H. Hoover, Jr., who is also the sole shareholder of Hot Mix, Inc., a general contractor supplying paving materials and services used for road and highway construction. During the years

in question, Hot Mix had several wholly-owned subsidiaries, one of which was John L. Burns, Inc. ("Burns, Inc."), a general contractor in road grading and highway construction (Pet. App. A-7 to A-8). These corporations participated as a team in bidding on and participating in highway contracts (Pet. App. A-10 to A-11).

Fidelity & Casualty Company of New York ("Fidelity") guaranteed an $800,000 line of credit for Burns, Inc. and Hot Mix with the Commerce Union Bank of Nashville ("Bank"). E. H. Hoover, Jr., another individual, Hot Mix, and its wholly-owned subsidiaries, together executed a guaranty of repayment to the Bank of loans made under that line of credit. Petitioner was not a party to the guaranty agreement (Pet. App. A-11 to A-13).

Subsequently, Burns, Inc. and Hot Mix, as principals, and petitioner, as indemnitor, entered into a "general contract of indemnity" in which they agreed to indemnify Fidelity against any loss resulting from liability on any surety bond Fidelity might sustain on behalf of either of the principals (Pet. App. A-13). Hoover individually also pledged and assigned to Fidelity, as additional security, certain funds which were to be held in escrow (Pet. App. A-13 to A-14).

Burns, Inc. borrowed $700,000 from the Bank under the line of credit and, as of December 1, 1966, $594,000 remained due and payable. On that date, Fidelity demanded payment from Hoover personally. Hoover had already deposited with Fidelity sufficient collateral in cash and government securities, which Fidelity liquidated in accordance with Hoover's instructions.

Fidelity did not, however, apply the proceeds directly to the payment of the debt to the Bank. Instead, pursuant to an agreement between Hoover and Fidelity, the proceeds of the liquidated collateral were returned to Hoover in exchange for Hoover's effectuation of the following series of transactions: Hoover gave petitioner a check for $594,000, receiving in return a five percent demand promissory note in the same amount; petitioner gave Burns, Inc. a certified check for $594,000 and received in return another five percent demand promissory note for the same amount; and Burns, Inc. paid the Bank the $594,000 due, thus releasing Fidelity from any obligation. Burns, Inc was not then or subsequently in a position to repay the funds advanced to it through petitioner (Pet. App. A-15 to A-19).

On December 31, 1966, petitioner charged off on its books as a bad debt $557,746.07 (representing the balance due on the $594,000 advance after crediting Burns, Inc. with the transfer to petitioner of its fixed assets) (Pet. App. A-19 to A-20). Petitioner's 1966 return claimed $557,746.07 as a bad debt deduction under Section 166 of the Internal Revenue Code of 1954, 26 U.S.C. 166. In the Tax Court and the court of appeals, petitioner claimed a deduction for this amount as an ordinary and necessary business expense under Section 162 or, alternatively, as a business loss under Section 165. The courts held that petitioner had acted merely as a conduit through which Hoover satisfied his guaranty obligation; that no debtor-creditor relationship existed in fact between petitioner and Burns, Inc. or between petitioner and Mr. Hoover; and, therefore, that petitioner was not entitled to any deduction on account of the transaction.

2. The essentially factual determinations by the Tax Court were upheld by the court of appeals as not clearly erroneous, and they warrant no further review.

It is well established that tax consequences turn on the economic substance rather than the form of the transaction. *Knetsch* v. *United States*, 364 U.S. 361; *Commissioner* v. *Court Holding Co.*, 324 U.S. 331; *Higgins* v. *Smith*, 308 U.S. 473; *Gregory* v. *Helvering*, 293 U.S. 465. As this Court noted in *Court Holding Co.* (324 U.S. at 334):

> [A] transaction must be viewed as a whole * * *. A [payment] by one person cannot be transformed for tax purposes into a [payment] by another by using the latter as a conduit through which to pass [funds]. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

Here, the substance of the transaction was Hoover's payment of his guaranty obligation out of funds held by Fidelity. The series of exchanges of checks and notes by which Fidelity permitted this to be accomplished added nothing of substance to the basic transaction.[1]

The Tax Court properly looked at the substance of the transaction in holding that petitioner acted as a

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[1]The series of transactions was barren of any business purpose, but it did have substantial tax purposes. Hoover was seeking to convert a capital loss in his own hands into an ordinary business loss for one of his corporations. At the same time, the note issued by petitioner to Hoover could have been used to characterize subsequent withdrawals of funds by Hoover as loan repayments rather than as dividends, thereby avoiding their taxation as income to Hoover.

mere conduit. Petitioner challenges (Pet. 12-20) the correctness of that holding, contending that the courts "looked to an isolated part of, rather than to the overall import of the entire transaction * * *" (Pet. 16). But the Tax Court's holding was based upon the overall import of the transaction, which the court concluded was nothing more than a device for Hoover's personal payment. This resolution by the Tax Court of a particular factual question creates no conflict among the courts of appeals.

Petitioner additionally contends (Pet. 8-12) that the courts below erred in not permitting a loss deduction under Section 165. Only losses actually sustained are deductible, however, and, as the Tax Court correctly found, petitioner as a mere conduit suffered no loss.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

JULY 1973.